SPECIAL REPORTS

International Tax Arbitrage: A Frozen Debate Thaws

by Thomas D. Greenaway

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Sovereign democratic nations make tax laws that reflect the needs and preferences of their citizens. This straightforward proposition suggests that tax laws may differ from country to country, and they do. Taxpayers may exploit some of these differences to their advantage. Over the past generation, global trade and cross-border investment boomed, and it also got easier to take advantage of tax law differences between nations. This combination — less friction and more opportunity — means that the exploitation of these differences played a growing role in tax planning. This is international tax arbitrage.

The U.S. government's response to international tax arbitrage has been mostly frozen for some time by opposing forces. Until recently, prevailing political and policymaking attitudes have either favored or been ambivalent to most international tax arbitrage strategies, or at least to their consequences. Attracting foreign capital into the United States and increasing the competitiveness of U.S. businesses abroad are two independent and central priorities for most U.S. fiscal policymakers. For the most part, policymakers have been persuaded that tolerating — if not encouraging — international tax arbitrage supports these two priorities.

That is, policymakers understand that a country that attacks international tax arbitrage probably restricts inbound capital flows, all else being equal. Congress has also been persuaded that attacking international arbitrage strategies employed in outbound U.S. investment structures hurts the global competitiveness of U.S. business. Furthermore, many policymakers — especially in the United States — defend idiosyncrasies in their tax systems against efforts to harmonize global tax laws.

However, at the administrative level, several basic principles support recent vigorous antiarbitrage enforcement efforts by the U.S. Internal Revenue Service. First, and most importantly, successful international tax arbitrage arrangements erode at least one country's tax base, undercutting the principal function of any tax system: collecting revenue. Almost all tax administrators (and many policymakers) think income should be subject to tax at least once, as a general rule. Second, tax administrators consider it a problem when taxpayers play one tax system off another. Taxpayers sometimes present inconsistent facts to two or more tax authorities, which is more than a problem. Finally, domestic taxpayers have neither room nor opportunity to exploit international tax arbitrage.

These opposing forces — to oversimplify, tax policymakers versus tax administrators — have caught many taxpayers in a state of limbo over the past decade. On examination, the IRS has disallowed the tax benefits of international tax arbitrage transactions that many taxpayers and their advisers thought (and still think) were perfectly legal under then-existing law and current tax policy. In many cases, the Service's vigorous antiarbitrage enforcement efforts have not been bolstered by published guidance, perhaps because such guidance would either be considered by Congress as overreaching, in conflict with broader policy goals, or both. Many of these cases have been resolved one-by-one in

IRS Appeals or in litigation, with no systemic resolution of the larger issues in play.

A new administration, a different Congress, and broader changes in attitudes toward structured financial products in general may all be working together to thaw the frozen antiarbitrage debate in favor of the tax administrator. But before explaining how a frozen debate may now be thawing, I explain the meaning of the phrase ''international tax arbitrage.'' I then note how growth in international tax arbitrage goes hand in hand with the continuing integration of the global economy. Then I survey the responses of U.S. policymakers and tax administrators to international tax arbitrage over the past decade, leading up to the present thaw. Finally, I close with a few thoughts about the future.

What Is International Tax Arbitrage?

The term ''international tax arbitrage'' refers to arrangements that exploit meaningful differences between the tax consequences of the same item in two or more jurisdictions.[1] For instance, one of the most basic tax law differences is the effective income tax rate. Some countries decide a low income tax rate is best. Other countries rely on a higher effective income tax rate. These decisions open up the most basic international tax planning opportunity: tax rate arbitrage.

Imagine you are the global CFO of a major multinational group. For sound cash management and other reasons, you decide that the group needs a stand-alone finance company. All else being equal, it makes sense to incorporate and manage the finance company in a low-tax jurisdiction, within a treaty network (to reduce withholding taxes on interest). Interest paid to the finance company by related operating companies in high-tax jurisdictions is generally deductible at a higher rate than the tax on the net interest income of the finance company. This is tax rate arbitrage. The more effective income tax rates differ, the better the arbitrage opportunity.

Tax rate arbitrage is roughly analogous to classic economic arbitrage: different prices for the same item in two or more different markets. An arbitrageur buys an item in a lower-priced market at the same time as he sells the same item in a higher-priced market. The difference, less transaction costs, is risk-free profit. In the same way, the creditor finance company in my example pays less in tax than the interest deduction yields the debtor operating company in tax savings. The difference, minus transaction costs,[2] is risk-free economic profit to the multinational group, assuming the operating company maintains its tax capacity in the high-tax jurisdiction — not a given in these days of net operating losses.

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International tax arbitrage includes more than exploiting tax rate differentials between different ''markets.''[3] Jurisdictions sometimes ''see'' the same entities and transactions in different ways, differences in perspective that can be exploited. Here are four well-known building blocks used by international tax planners to create these differences:

- dual-resident corporations, incorporated in one jurisdiction but managed and controlled in another;
- hybrid entities, taxed as a corporation in one jurisdiction, but considered a flow-through entity (or disregarded) in another;
- hybrid instruments, treated as debt or royalty rights in one jurisdiction but equity in another; and
- repurchase agreements, which are treated as a secured lending agreement in some jurisdictions (the United States and the United Kingdom most notably), but as distinct sales or exchanges in other jurisdictions.

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[1] *See* Philip R. West, ''Foreign Law in U.S. International Taxation: The Search for Standards,'' 3 *Fla. L. Rev.* 147, 171 (1996). Other good articles not cited elsewhere in this article include H. David Rosenbloom, ''The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System,''' 53 *Tax L. Rev.* 137 (2000); L.G. ''Chip'' Harter, ''International Tax Arbitrage: Is It a Problem? Whose Problem Is It?'' 41 *Tax Mgmt Memo.* 139 (2000); Julie Roin, ''Taxation Without Coordination,'' 31 *J. Legal Stud.* 61 (2002); and David J. Shakow, ''Confronting the Problem of Tax Arbitrage,'' 43 *Tax L. Rev.* 1 (1987).

[2] For the sake of simplicity, I include the risk of successful challenge to the deduction by the high-tax jurisdiction tax administrator as a transaction cost here.

[3] Some scholars try to exclude tax rate arbitrage from the definition of international tax arbitrage. If '''international tax arbitrage' is nothing but a colorful label capturing the entirely ordinary observation that national tax laws differ, then we will have lost any reason to seek an explanation of governmental reaction in relation to a distinct phenomenon of international tax arbitrage.'' Mitchell A. Kane, ''Strategy & Cooperation in National Responses to International Tax Arbitrage,'' 53 *Emory L. J.* 89, 97 (2004).

These structures — and others — can provide the meaningful difference in tax treatment essential to a successful international tax arbitrage strategy.

These building blocks may be used to create international tax arbitrage transactions or arrangements. Gregory May, in a 2007 article,[4] set out a taxonomy of international tax arbitrage:

- multiple deductions;
- domestic deduction without foreign inclusion;
- domestic deduction with foreign tax credit abroad;
- foreign deduction without domestic inclusion;
- foreign deduction with U.S. foreign tax credit;
- multiple tax credits; and
- treaty benefits without foreign taxation.

Most arbitrage strategies use one or more of the building blocks listed above to create one of these seven types of tax-saving mechanisms. Nevertheless, comprehensive classification and organization is difficult, since arbitrage is opportunistic.[5] Some of the examples described below help illustrate the phenomenon.

More Opportunity, Less Friction

Rapid growth in cross-border trade and capital flows has opened more opportunities for international tax arbitrage, and it has become easier over time to put on tax arbitrage transactions, for many of the same reasons. It is taken for granted that the world has become more interconnected, but it is worth pausing here to emphasize the point. Cross-border income on assets boomed in the last generation. Foreign investment assets almost tripled from 1999 to 2007, from $34.9 trillion to $92.6 trillion.[6] As Figure 1 shows, capital has become more and more mobile over the past several generations.

These trends did not develop in a vacuum. For decades, supranational agreements and organizations like the General Agreement on Tariffs and Trade, IMF, and WTO — led by the United States — have encouraged the development of global trade and investment by word and deed. For instance, foreign exchange controls have largely disappeared from most important markets (except China).[7] Largely stable geopolitics has also been a major factor. Better communication, technology, and travel also foster cross-border trade and investment. Transaction costs, both in making global investments and accounting for them, have been driven down by automation and computers. One small example makes the point: I keep a brokerage account for my family's investments. The broker's Web site tells me I can trade equities on more than 60 stock exchanges in more than 40 countries, with automated management of cash balances in many currencies. From my kitchen counter, on my laptop. Such options were not available to puny retail investors like me a generation ago. Large investors and companies have all the more options, with more certainty and at less cost, than ever before.

Of course, almost all these trends reversed in 2008. Global capital flows basically stopped for a short time,[8] and investors everywhere pulled back in favor of less risky positions.[9] Counterparties disappeared, and cheap, available debt — essential to many international tax arbitrage arrangements — dried up. Most importantly, tax minimization planning for many companies and investors fell by the wayside, as cash preservation and economic survival became paramount concerns.

Recent Tax History

The modern U.S. history of international tax arbitrage begins in 1986. First, Congress dropped the top corporate income tax rate from 46 percent to 36 percent, setting off a series of statutory corporate tax rate reductions that continues to cascade around the world.[10] Second, Congress disallowed dual consolidated losses incurred by dual-resident corporations.[11] Some countries impose corporate income tax based on residence, testing for residence by asking where the corporation is managed and controlled.[12] In contrast, the United States subjects all corporations incorporated in the United States to the federal income tax, regardless of where they are managed and controlled. This difference allowed loss-making U.S. corporations managed and controlled elsewhere to be members of two consolidated groups, one in the United States and one in another country. Congress passed dual consolidated

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[4]Gregory May, ''Getting Realistic About International Tax Arbitrage,'' *Taxes* (Mar. 2007).

[5]*Id.* at 51.

[6]Diana Farrell et al., McKinsey Global Institute, ''Mapping Global Capital Markets: Fifth Annual Report,'' 23 (Oct. 2008).

[7]*See* Articles of Agreement of the International Monetary Fund, Article VIII section 2, *available at* http://www.imf.org/external/pubs/ft/aa/aa08.htm.

[8]Total cross-border capital flows dropped 82 percent — from $10.2 trillion to $1.9 trillion — between 2007 and 2008. Charles Roxburgh et al., McKinsey Global Institute, ''Global Capital Markets: Entering a New Era'' (Sept. 2009).

[9]For example, the World Bank reports that net capital inflows to developing countries dropped about 40 percent between 2007 and the end of 2008. *See* World Bank, ''Global Development Finance,'' 38 (2009).

[10]*See* Michael Keen and Alejandro Simone, ''Is Tax Competition Harming Developing Countries More Than Developed?'' *Tax Notes Int'l*, Special Supplement, June 28, 2004, p. 1317.

[11]IRC section 1503(d).

[12]For a short history of the development of the management-and-control test in the United Kingdom, see Jonathan Schwartz, ''Management-Based Definition for Domestic Corporations,'' 29 *ABA Section of Taxation Newsquarterly* 1 (Fall 2009).

Figure 1. U.S. Cross-Border Income Receipts and Payments, 1960-2008
(billions of U.S. dollars)

Source: Bureau of Economic Analysis, U.S. International Transactions Accounts Data.

loss provisions barring U.S. consolidated groups from using the loss twice. Congress did not offer a positive rationale to support the dual consolidated loss provisions, relying instead on a negative justification for the provision. As the conference report put it: ''The conferees are not aware of a case where the use of one company's deduction by two other companies in two tax jurisdictions makes sense as a matter of tax policy.''[13] The legislative history also suggests that Congress acted to protect domestic businesses from foreign multinationals regarding U.S. acquisitions.

A decade later, the 1996 check-the-box regulations gave a mighty boost to international tax arbitrage. Transaction costs and uncertainty are two big constraints on any potential arbitrage strategy. Arbitrage requires stability, predictability, and low transaction costs. The check-the-box regime provides all three. Check-the-box lowered choice-of-entity transaction costs and uncertainty to almost zero for U.S. tax planning purposes.[14] Even before the check-the-box regime was implemented, Treasury and the Service recognized the boost an elective entity regime could give international tax arbitrage, with typical understatement: ''An elective approach could expand the potential that exists

[13]Conf. Rep. 99-841, 1986-3 C.B. (Vol. 4) 1, 657.

[14]''The relatively frictionless ability to change foreign entity form for U.S. tax purposes, along with the increased ability to employ inconsistently classified entities in foreign structures to achieve planning objectives, has made elective entity classification an unparalleled planning tool to minimize both foreign and U.S. tax on foreign earnings.'' ''Report of the American Bar Association Section of Taxation's Task Force on International Tax Reform,'' 59 *Tax Law.* 649, 738 (2006).

under the current classification regulations for hybrid structures.''[15] They were right; it did.

In a 1997 technical advice memorandum, the IRS confirmed that aircraft could have two tax owners, one for U.S. tax purposes and another for Japanese tax purposes. ''We conclude that Taxpayer in this case has properly established that it retained the benefits and burdens of ownership of the aircraft for federal income tax purposes, notwithstanding that the aircraft were also treated as owned by Corporation J for Japanese tax purposes.''[16] This memorandum offers a rare instance of the IRS explicitly endorsing a multiple deduction arbitrage strategy (called a double-dip lease), that had already gained widespread acceptance among tax practitioners.

In 1997 and 1998, soon after the check-the-box regulations were finalized, Congress and Treasury began trying to extinguish at least some of the arbitrage strategies the check-the-box regulations had fueled. In 1997 Congress passed section 894(c), which bars hybrid entities from claiming reduced withholding tax rates on some outbound payments. This provision targeted lending arrangements between particular Canadian corporations and their U.S. limited liability company subsidiaries.[17] In section 894(c)(2), Congress also explicitly gave Treasury authority to clarify ''those situations involving hybrid entities in which taxpayers are entitled to treaty benefits and those situations in which they are not.''[18] Congress offered no suggestions in the legislative history as to how Treasury should draw the line, other than to note that proposed and temporary regulations issued in 1997 were consistent with the conference agreement provision.[19]

In late 1997 and early 1998, Treasury and the Service announced several anti-cross-border tax arbitrage initiatives. Starting in December 1997, in Notice 98-5, Treasury and the IRS denounced some ''cross-border tax arbitrage transactions that permit effective duplication of tax benefits,'' mostly FTCs.[20] In the notice, Treasury and the IRS tried to distinguish ''abusive'' transactions from the main run of international tax arbitrage:

> These duplicate benefits generally can result where the U.S. and a foreign country treat all or part of a transaction or amount differently under their respective tax systems. In abusive arrangements involving such transactions, the U.S. taxpayer exploits these inconsistencies where the expected economic profit is insubstantial compared to the foreign tax credits generated.

The first sentence quoted above states a fact. The second sentence announces an ''insubstantial'' profit-to-credit ratio as the test for abusiveness, which was to be enshrined in forthcoming regulations. The notice also explained in some detail how to test for insubstantial expected economic profit.[21] By implication, arbitrage transactions with substantial economic profit were fine.

Second, in January 1998 Treasury and the IRS issued Notice 98-11,[22] which promised to issue regulations to limit the use of ''hybrid branches'' to circumvent subpart F. Subpart F generally provides that U.S. shareholders of controlled foreign corporations must currently include in income interest earned by their CFCs. Subpart F, however, also contains a ''same-country exception'': interest paid by one CFC to another CFC in the same country is not currently includable in the U.S. shareholder's income,[23] as interest otherwise would under subpart F.[24] A typical hybrid branch financing structure that takes advantage of this exception is shown in Figure 2.

Country B levies little if any corporate income tax. For Country A purposes, BR 1 is treated as a separate entity from CFC 2, and CFC 1 takes a deduction for interest paid to BR 1. For U.S. purposes, the loan is between CFC 1 and CFC 2, since BR 1 is disregarded. CFC 2 does not pay Country A income tax on the interest paid to BR 1. USCo does not pay current U.S. tax on the BR 1 interest income either, because of the same-country interest exception to subpart F. Therefore, the worldwide group has the benefit of a current deduction in Country A for CFC 1, while the corresponding income inclusion is generally deferred for Country A purposes unless and until BR 1 pays a dividend to CFC 2 — that is, indefinitely.

This sort of structure, according to the notice, created results inconsistent with the policies and rules of subpart F. ''Treasury and the Service believe that it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income.'' As with Notice 98-5, Treasury and the IRS

[15] Notice 95-13, 1995-1 C.B. 297.

[16] TAM 9748005 (Aug. 19, 1997).

[17] Conf. Rep. 105-220, 1997-4 C.B. (Vol. 2) 1457, 2043.

[18] *Id.*

[19] *Id. See also* T.D. 8722, 1997-2 C.B. 81.

[20] 1998-1 C.B. 334.

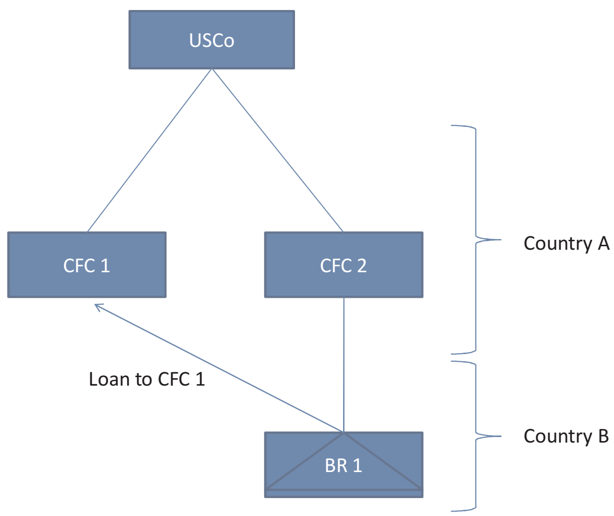
[21] Most controversially, the notice declared that foreign taxes were to be considered an expense in the calculation (even though they would be creditable). This argument has not fared well in litigation. *Compaq Computer Corp. & Subs. v. Commissioner*, 277 F.3d 778, 785 (5th Cir. 2001); *IES Industries, Inc. v. United States*, 253 F.3d 350, 354 (8th Cir. 2001). Yet the IRS still makes the argument, citing the support of professors and several distinguished members of the New York tax bar as authority. *E.g.*, IRS CCA 200826036, 2008 WL 2554998.

[22] 1998-1 C.B. 433, *withdrawn*, Notice 98-35, 1998-2 C.B. 34.

[23] IRC section 954(c)(3).

[24] IRC section 954(c)(1)(A).

Figure 2. Typical Hybrid Branch Finance Structure Using the 'Same-Country Exception'



promised to follow up with regulations ''to prevent these types of hybrid branch arrangements.''

Next, on February 2, 1998, the Clinton administration released its fiscal 1999 budget proposal. Consistent with notices 98-5 and 98-11, the administration proposed that Congress enable Treasury regulations regarding the use of hybrids. Here is how the administration described its proposal:

> The proposal would direct the Secretary to prescribe regulations clarifying the tax consequences of hybrid transactions. The regulations would set forth the appropriate tax results under hybrid transactions in which the intended results are inconsistent with the purposes of U.S. tax law (including treaties), and would make clear that such results obtain in hybrid transactions in which the intended results are not inconsistent with the purposes of U.S. law. In particular, the regulations would not be authorized to deny tax benefits or results that arise in connection with hybrid transactions solely because such transactions involve the inconsistent treatment of entities, items and transactions (i.e., ''tax arbitrage'').[25]

Note that the proposal did not attack all tax arbitrage. Instead, the perceived problem was hybrid transactions with ''intended results . . . inconsistent with the purposes of U.S. tax law,'' an ambiguous standard, to say the least. This teleological focus on consequences to distinguish good transactions from bad is a recurring theme in the government's episodic campaign against international tax arbitrage.

In March 1998 Treasury made good on the promise of Notice 98-11, issuing temporary and proposed regulations (the 1998 regulations).[26] They did not last long. As the staff of the Joint Committee on Taxation recently put it: ''The issuance of Notice 98-11 and the temporary and proposed regulations provoked great controversy among taxpayers and members of Congress.''[27] Indeed, the chair of the House Ways and Means Committee sent several strong letters to the Treasury secretary on the matter.[28]

Almost immediately after the release of the 1998 regulations, the Senate passed a sense of the Senate resolution as an amendment to the IRS restructuring bill. The sense of the Senate provided that Congress, not Treasury or the IRS, should determine the international tax policy issues relating to hybrid transactions under subpart F of the code.[29] Furthermore, the sense of the Senate also provided that Treasury and the IRS should limit any regulations issued under Notice 98-5 to the specific transactions described in the notice, although it did not restrict the ability of Treasury and the IRS to address ''abusive transactions.''[30]

In reaction to the hostile response from Congress, Treasury withdrew both Notice 98-11 and the 1998 regulations in Notice 98-35.[31] Treasury, however, did not immediately give up on its plans to issue guidance on hybrid transactions. Instead, Notice 98-35 pushed out the effective date of any final regulations, with generous transition relief, and announced a three-part test as to when payments between CFCs and hybrid branches would be recharacterized as subpart F income.

Notice 98-35 did not mollify Congress. Although the conference bill for the IRS Restructuring Act did not include the provisions from the Senate bill described above (since Notice 98-11 and the 1998 regulations had been withdrawn), the conference report put a finishing coda on the episode:

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[25]''General Explanation of the Administration's Revenue Proposals,'' para. 519 (Feb. 2, 1998), *Doc 98-4800* or *98 TNT 22-6*.

[26]T.D. 8767, 1998-1 C.B. 875.

[27]''Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part III: Provisions Related to the Taxation of Cross-Border Income and Investment'' (hereinafter 2010 Bluebook), slip copy at 108. For examples of the controversy, see, *e.g.*, Notice 98-11 Coalition Statement on Expanded Regulatory Authority (Feb. 25, 1998), *Doc 98-7415* or *98 TNT 38-42*; ''TEI Calls Hybrid Arrangements Notice 'Poor Tax Policy,''' (Mar. 23, 1998), *Doc 98-9534* or *98 TNT 54-34*.

[28]*E.g.*, William Archer to Robert Rubin, Mar. 20, 1998, *Doc 98-10409* or *98 TNT 59-44*.

[29]S. Rep. No. 105-174, 1998-3 C.B. 537, 650.

[30]*Id.*

[31]Notice 98-35, 1998-2 C.B. 34; T.D. 8827, 1999-2 C.B. 120.

> The conferees expect that Congress will consider international tax policy issues relating to the treatment of hybrid transactions under the subpart F provisions of the Code, and will consider taking legislative action as deemed appropriate. In this regard, the conferees expect that the Congress will consider the impact of any legislation or administrative guidance in this area on affected taxpayers and industries.[32]

The conference report ''strongly recommended'' that Treasury take into account the impact of guidance in this area on affected taxpayers and industries.[33] The conference report also stated, however, that no inference was intended regarding the authority of Treasury or the Service to issue such guidance.[34]

In 2001 the new Treasury Secretary took a different approach to the question of international tax competition than his predecessor. For instance, Treasury Secretary Paul O'Neill explained the Bush administration's reaction to the OECD harmful tax practices initiative:

> I was troubled by the notion that any country, or group of countries, should interfere in any other country's decisions about how to structure its own tax system. I felt that it was not in the interest of the United States to stifle tax competition that forces governments — like businesses — to create efficiencies.[35]

Tax competition — and its free-market cousin, tax arbitrage — was to be supported, not squelched.

With that, the policymaking freeze set in. Congress has not returned to the issue of hybrids in any meaningful way since 1998.[36] Treasury never issued the regulations promised in Notice 98-35 in final form. For the most part, Treasury has refrained from issuing any regulations attacking international tax arbitrage transactions.[37] Indeed, at least one Treasury official publicly remarked that there was nothing wrong with international tax arbitrage, in 2006.[38] That conclusion was bolstered, perhaps, by the strong inference in the 1998 conference report that the tax policy issues international tax arbitrage transactions present are for Congress, not Treasury, to decide.

However, the IRS — the tax administrator — was not content to leave international tax arbitrage alone. In 2006 then-IRS Commissioner Mark Everson gave voice to the concerns of tax examiners the world over when he told a large group of tax executives: ''It is not intended that a company can do business in two countries that are not tax havens and pay tax in neither through the use of hybrid instruments.''[39] The Service put teeth into this declaration by naming international hybrid instruments a Tier I enforcement strategy.[40] A directive issued by the International Hybrid Transaction Issue Management Team states: ''The field [that is, examiners] should review and challenge all arguments by taxpayers who claim that these [international hybrid instrument] transactions are debt or equity for U.S. tax purposes.''[41] Debt-in-the-U.S. hybrid transactions in particular have been aggressively challenged on examination as earnings stripping devices, without the benefit of any specific public guidance from the IRS Office of Chief Counsel or Treasury.

In examination, the Service does not directly attack the arbitrage feature of these debt-in-the-U.S. hybrid financing structures. Arbitrage is the rarely discussed elephant in the room. Perhaps because of the lack of published guidance from chief counsel, possibly because of the ambivalence from Treasury, and maybe because of the 1998 congressional admonition, the arguments the IRS uses in examination to combat international tax arbitrage arrangements are more general — debt versus equity, for instance. The problem with these general arguments: They prove too much. For instance, examination attacks repurchase agreements used in hybrid financing structures, but the arguments

[32]Conf. Rep. 105-599, 1998-3 C.B. 747, 1068.

[33]*Id.*

[34]*Id.*

[35]OECD Harmful Tax Practices Initiative: Hearing Before the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, 107th Cong. 1 (2001) (statement of Paul H. O'Neill, Secretary of the Treasury), *available at* http://hsgac.senate.gov/071801_psioneil.htm.

[36]Some tax treaties negotiated and ratified since 1998 restrict the use of hybrids to achieve treaty benefits, but these treaties do not affect arbitrage strategies not based on treaties.

[37]*See*, *e.g.*, final dual consolidated loss regulations, T.D. 9315, 2007-1 C.B. 891 (Mar. 27, 2007) (''The IRS and Treasury Department recognize that this type of [domestic reverse hybrid] structure results in a double dip similar to that which Congress intended to prevent through the adoption of section 1503(d). However, the IRS and Treasury Department believe that a domestic reverse hybrid is neither a dual resident corporation nor a separate unit and, therefore, is not subject to section 1503(d).'').

[38]Sheryl Stratton, ''Tax Arbitrage Not Inherently 'Evil,' Treasury Official Says,'' *Tax Notes Int'l*, Jan. 23, 2006, p. 271, *Doc 2006-787*, or *2006 WTD 10-2*.

[39]Mark Everson, IRS Commissioner, address at Tax Executives Institute (Oct. 23, 2006), *as reported in* Philip R. West, ''Anti-abuse Rules and Policy: Coherence or Tower of Babel?'' *Tax Notes Int'l*, Mar. 31, 2008, p. 1161, *Doc 2008-724*, or *2008 WTD 66-8*, at footnote 17.

[40]This Tier I enforcement issue was recently downgraded to ''monitoring status,'' which implies that the IRS has provided the necessary direction to the field, issued appropriate procedural guidance and legal position, and developed a resolution strategy. *See* Issue Tiering Frequently Asked Questions — LMSB, *available at* http://www.irs.gov/businesses/corporations/article/0,,id=204371,00.h tml (last updated Mar. 18, 2009).

[41]Memorandum from Walter L. Harris, director, field specialists (June 15, 2007), *available at* http://www.irs.gov/businesses/article/0,,id=171462,00.html.

the Service uses — if correct — would disrupt settled law on the taxation of the most basic domestic repurchase agreements widely used for cash management.

Over the past five years, there has been one notable exception to the general pattern of policy silence paired with energetic enforcement on arbitrage transactions: the so-called FTC generators. Even though Treasury and the IRS withdrew Notice 98-5 in 2004,[42] after a brief lull, the IRS redoubled its attack on some of the transactions described in Part II of Notice 98-5 using the economic substance doctrine, section 269, and other existing law arguments.[43] The Service calls these transactions FTC generators, and several cases have been designated for litigation by chief counsel.

There has been one notable exception to the pattern of policy silence paired with energetic enforcement on arbitrage transactions: the so-called FTC generators.

FTC generators — if they work — can be scaled up to wipe out almost any desired amount of U.S. tax liability, assuming a willing foreign counterparty. The Service and Treasury candidly admit that these structured financing transactions are too much of a drain on the fisc to tolerate.[44] Therefore, Treasury and the IRS issued regulations that bar FTCs thrown off by some ''highly structured passive investment arrangements.''[45] The positive policy rationale for these regulations is difficult to divine.[46] In any event, since FTC generators have been labeled ''abusive'' by the Service, they arguably do not fall afoul of the 1998 congressional warning against regulation in this area,[47] since the 1998 sense of the Senate carved out abusive transactions.

[42]Notice 2004-19, 2004-1 C.B. 606.

[43]*E.g.*, IRS CCA 200826036.

[44]''It is inconsistent with the purpose of the foreign tax credit to permit a credit for foreign taxes that result from intentionally structuring a transaction to generate foreign taxes in a manner that allows the parties to obtain duplicate tax benefits and share the cost of the tax payments. The result in these structured arrangements is that both parties as well as the foreign jurisdiction benefit at the expense of the U.S. fisc.'' 72 *Fed. Reg.* 15081-15091, 2007-1 C.B. 1015.

[45]*Id.*

[46]Kevin Dolan, ''Foreign Tax Credit Generator Regs: The Purple People Eater Returns,'' *Tax Notes Int'l*, July 16, 2007, p. 251, *Doc 2007-15194*, or *2007 WTD 141-8*.

[47]*See* text surrounding note 30, above.

The Way We Live Now

The environment is much less hospitable to international tax arbitrage now than it was two years ago. Tax arbitrage is a subset of regulatory arbitrage, which has emphatically fallen out of favor with policymakers.[48] Moreover, international capital flows almost stopped between 2007 and 2008, as investors pulled back in favor of less risky positions.[49] Stability and predictability — keys to risk-free arbitrage — have been in short supply. Many large corporate taxpayers have no need for tax savings strategies in the near term — they generated huge net operating losses in 2008. Perhaps most importantly, the demand for tax revenue is strengthening.

Moreover, U.S. international tax reform is more likely in the next two years than at any time in the last generation.[50] The current regime has many critics. For instance, the American Bar Association Section of Taxation's Task Force on International Tax Reform, cochaired by Stephen Shay, who has since been appointed Treasury deputy assistant secretary (international tax affairs), characterized current U.S. international tax rules as ''deficient'' and ''dysfunctional'' in a blistering takedown.[51]

The JCT staff now sees a broader opportunity to take on international tax arbitrage, as explained in its analysis of the president's budget proposal to limit the use of check-the-box subpart F planning:

> While the proposal would address a variety planning [sic] techniques that facilitate the avoidance of subpart F, it would leave untouched a significant range of other tax minimization strategies that also make use of inconsistent U.S. and foreign classifications. The proposal thus presents an opportunity to consider more generally the circumstances in which any inconsistency between

[48]*See*, *e.g.*, Remarks by the President on 21st Century Financial Regulatory Reform, *available at* http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/.

[49]Martin Wolf, ''New Dynamics,'' *Financial Times*, Future of Finance 3 (Nov. 9, 2009).

[50]Kristen A. Parillo, ''Broad International Tax Reform Likely to Be on Congress's 2010 Agenda, Practitioners Say,'' *Doc 2009-27615* or *2009 WTD 240-3*.

[51]ABA task force report, *supra* note 14, at 717. ''The current international tax rules ''distort investment choices. They do not increase U.S. investment (or tax revenue), they encourage shifting it to other countries. The rules are not easily administered by taxpayers or the government. They are in many respects too complex for many Service auditors to understand and therefore for the government to audit effectively. Finally, in result they are unfair — to those who do not have foreign income and to those who do have foreign income but do not engage in sophisticated tax planning.'' *Id.*

the U.S. and foreign classifications of a business entity should be tolerated.[52]

The use of the word ''tolerated'' does not bode well for check-the-box hybrids specifically or international tax arbitrage more generally.

Where to Next?

With these clear signs of thaw in the policymaking freeze, a few thoughts about the future are in order. First, the recent short-term reversal in global capital flows will not last forever. Capital is coming out from hiding, looking for returns. The trend in favor of increased cross-border capital flows will reestablish itself in time. The technological and geopolitical forces that fostered greater globalization are still in place, even though the dominance of the reigning free-market model may have been temporarily shaken at home and abroad.

Second, for the time being at least, the United States probably cannot afford to stanch the flow of inbound foreign capital, whether it is in the form of direct investment, portfolio investment, loans, or bank deposits. Perhaps in time the U.S. government will abide higher costs of capital, but not now, with more than 10 percent unemployment and the Federal Reserve providing massive liquidity to the financial system. An aggressive move by Congress or Treasury to close current inbound arbitrage opportunities may crimp inbound capital flows into the United States, all else being equal. Recent history shows that there is more than a grain of truth to the quip: ''Money goes where it wants and stays where it is well treated.''[53] Restricting inbound capital may drive up the cost of capital inside the United States, and work at cross-purposes with broader policy goals.

Looking to the intent or purpose of the U.S. international tax rules to distinguish good tax arbitrage from bad generally fails for several reasons. For one thing, the basic structure of the international tax rules were set generations ago. The world is different now. Furthermore, Congress added complexity, exceptions, elections, and antiabuse provisions to the international tax rules over the intervening half-century, often without any overarching policy guiding or grounding the process. Given the deficient and dysfunctional nature of the current rules,[54] any good-faith attempt to demonstrate the general purpose of the international tax rules generally collapses under the weight of statutory and regulatory exceptions, exclusions, and contradictions. Finally, divining the intent of Congress at the best of times is not an exact science. Taxpayers and the IRS need clear guidance; deciding hard cases by arguing over what Congress intended decades ago is not a good solution.

The notion that the international tax system demands that items of income must be taxed at least once — the single tax principle[55] — is a nonstarter. Mitchell Kane stopped the single tax principle in its tracks by pointing out two insurmountable hurdles:

- no international consensus holds that each sovereign nation should tax every item of income to every taxpayer at a nonzero rate; and
- no international consensus exists as to the meaning of income.[56]

There is some support, in theory, for the single tax principle in treaty cases, but since treaty benefits are elective, no rational taxpayer would elect into single taxation under a treaty when double nontaxation is a viable option.

> **The government should not focus on tax consequences to determine whether a transaction is abusive or innocuous.**

More generally, there should be a positive basis supporting our tax rules. The government should not focus on tax consequences to determine whether a transaction is abusive or innocuous. A means-justifies-the-ends approach carries no persuasive weight. As the Fifth Circuit put it in *Compaq*: ''The Commissioner . . . has provided no reason to endorse its approach. . . . That the Government would get more money from taxpayers does not suffice.''[57] Whether tax benefits flow from a transaction should be determined by examining the transaction itself on objective facts, not by reference to how much tax it avoids. Fidelity to the law also requires that the IRS treat like cases alike. The current impasse between policymakers and enforcement means that the Service cannot point to the most

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[52]2010 Staff, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal — Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* 114 (2009 Joint Committee Print).

[53]John Micklethwait and Adrian Wooldridge, *The Company: A Short History of a Revolutionary Idea*, 142 (Modern Library, 2003).

[54]ABA task force report, *supra* note 14, at 718.

[55]Reuven S. Avi-Yonah, ''Commentary,'' 53 *Tax L. Rev.* 167, 171 (2000).

[56]Kane, *supra* note 3, at 114-115.

[57]*Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 785 (5th Cir. 2001).

bothersome distinguishing feature of hybrid transactions — their hybridity — as its basis for attacking them.

Arbitrage is a natural byproduct of a world with different tax rules and concepts. In such a world, overlaps and gaps will always appear in the tax map. Tax treaties address the overlaps, but no amount of work short of unitary international tax reporting will close all the gaps. Government may, of course, try to keep taxpayers away from some of the gaps by fiat, as with the FTC generator regulations. Such an approach, however, is necessarily reactive, inefficient, expensive, and unpredictable.

If international tax arbitrage is a problem, it is more a symptom than a disease. The fix for the larger problem:

- simplify the rules; and
- minimize differences with our treaty partners.

Arbitrage flourishes in the overly complex current code and regulations. By broadening the corporate tax base and lowering the rate, Congress would help reduce both the opportunity and the motivation for U.S. taxpayers to put on international arbitrage transactions. Likewise, if arbitrage truly is a problem, perhaps the United States should redouble its efforts to work with supranational unifying organizations like the OECD to bring the world's tax laws into greater harmony.

In closing, I fully support drastic simplification of the U.S. tax rules, not so much to close off arbitrage, but for efficiency and fairness reasons. Fewer arbitrage opportunities would result from a simpler tax code, especially if those responsible for U.S. tax reform consider the global context in which those rules will be deployed. Idiosyncrasies will continue to be exploited by international tax arbitrageurs, no matter what. ◆